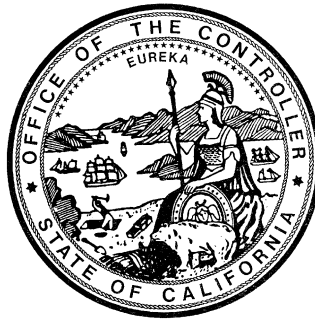


CALIFORNIA LOTTERY

Audit Report

OTTO CONSTRUCTION CONTRACT

July 15, 2009, through September 30, 2010



JOHN CHIANG
California State Controller

December 2011



JOHN CHIANG
California State Controller

December 16, 2011

Alex E. Fortunati, Commissioner
California Lottery Commission
600 North Tenth Street
Sacramento, CA 95811

Dear Mr. Fortunati:

The State Controller's Office (SCO) audited the California Lottery's (Lottery) Otto Construction contract for the period of July 15, 2009, through September 30, 2010.

Our audit disclosed the following deficiencies in the Lottery's fiscal controls over payments and its monitoring of the Otto Construction contract. The Lottery:

- Lacked adequate support for the contractor's self-performed work totaling \$1,328,292, and overpaid the contractor for subcontractors' work totaling \$239,281;
- Failed to provide the contractor with a prior written authorization for additional preconstruction services that the contract requires before commencement of work and/or before compensation for said services;
- Lacked evidence for liability insurance coverage;
- Did not comply with its contract-required as-built drawings and specifications terms; and
- Did not comply with its contract-required daily reports terms and conditions.

In addition, we noted that the depreciation cost for the new building will be included in the Lottery's Administrative Expense, which is limited to 13% of total revenues. The Lottery's management should comply with California Government Code section 8880.64 and ensure that expenses do not exceed the new limitation.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/sk

cc: Linh Nguyen, Acting Director
California Lottery
Michael T. Ota, Deputy Director
Finance Division, California Lottery
Roberto Zavala, Chief
Internal Audits, California Lottery
Terry Murphy, Deputy Director
Operations Division, California Lottery

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Audit Report

Summary

The State Controller's Office (SCO) audited the California Lottery's (Lottery) Otto Construction Contract No. 14379 for the period of July 15, 2009, through September 30, 2010.

The purpose of our audit was to determine whether the Lottery is complying with sound financial and program management practices in administration of the contract.

Our audit disclosed the following deficiencies in the Lottery's fiscal controls over payments and its monitoring of the Otto Construction contract. The Lottery:

- Lacked adequate support for the contractor's self-performed work totaling \$1,328,292, and overpaid the contractor for subcontractors' work totaling \$239,281;
- Failed to provide the contractor with a prior written authorization for additional preconstruction services that the contract requires before commencement of work and/or before compensation for said services;
- Lacked evidence for liability insurance coverage;
- Did not comply with its contract-required as-built drawings and specifications terms; and
- Did not comply with its contract-required daily reports terms and conditions.

In addition, we noted that the depreciation cost for the new building will be included in the Lottery's administrative expense, which is limited to 13% of total revenues. The Lottery's management should comply with California Government Code section 8880.64 and ensure that expenses do not exceed the new limitation.

Background

By authority of the California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of the public revenues."

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.67, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

The Lottery entered into a contract with Otto Construction (Contract No. 14379) to provide pre-construction and construction services to construct the new Lottery headquarters building in Sacramento. The original contract was for the period of August 3, 2009, through December 31, 2011, with a guaranteed maximum price of \$63.8 million.

The contractor was contracted to provide the following services:

- Demolish Building D, and construct Building E in its place;
- Construct Building E, a six-story steel structure with a gross area of approximately 155,560 square feet;
- Design the Lottery's new headquarters building to achieve a minimum Gold Leadership in Energy and Environmental Design (LEED) certification, with the goal being Platinum certification; and
- Construct Building E to be located on the northeast corner of the property fronting both North 10th Street and the future extension of Vine Street.

Objectives, Scope, and Methodology

The purpose of the audit was to determine whether the Lottery's fiscal controls over payments and monitoring procedures are adequate to ensure that Otto Construction complies with the terms and conditions of the Otto Construction's contract with the Lottery (Contract No. 14379).

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The specific objectives of the audit were to determine whether the Lottery is:

- Ensuring that contract payments are legal and proper;
- Abiding with state laws, rules, regulations, and policies with regards to the contract;
- Monitoring the contract for compliance; and
- Ensuring that the contractor provides the Lottery with specified deliverables according to the terms and conditions of the contract.

The final review of the construction cost does not take place until the completion of the project. Therefore, we cannot render an opinion until the completion of the construction project. We will perform a review after the contract has been closed out. The audit period was July 15, 2009, through September 30, 2010, and included, but was not limited to, the following audit procedures:

- Reviewing Otto Construction contract and subcontracts, contract law, regulations, rules, Lottery policies, and related accounting records;
- Reviewing work performed by any external audit organization or by any other Lottery unit;
- Interviewing and observing individuals involved in the development, authorization, and monitoring of the Otto Construction contract;
- Performing tests of procedural compliance and tests of payments, as we deemed necessary; and
- Obtaining an understanding of components of internal controls sufficient to conduct the audit.

We did not audit Otto Construction's and the Lottery's financial statements. We limited our audit scope to planning and performing audit procedures necessary to obtain reasonable assurance that the Lottery's monitoring of the Otto Construction contract was adequate to ensure compliance with the terms and conditions of the contract and payments are legal and proper. In addition, the Lottery is abiding with state laws, rules, regulations, and policies with regards to the contract.

Conclusion

Our audit disclosed that the Lottery did not follow the terms and conditions stipulated in the Lottery's Otto Construction contract and the Contract Manager's Handbook. We noted the deficiencies listed below. The Lottery:

- Lacked adequate support for the contractor's self-performed work totaling \$1,328,292, and overpaid the contractor for subcontractors' work totaling \$239,281 (Finding 1);
- Failed to provide the contractor with a prior written authorization for additional preconstruction services that the contract requires before commencement of work and/or before compensation for said services (Finding 2);
- Lacked evidence for liability insurance coverage (Finding 3);
- Did not comply with its contract-required as-built drawings and specifications terms (Finding 4); and
- Did not comply with its contract-required daily reports terms and conditions (Finding 5).

In addition, we noted that the depreciation cost for the new building will be included in the Lottery's administrative expense, which is limited to 13% of total revenues. Lottery's management should comply with California Government Code section 8880.64 and ensure that expenses do not exceed the new limitation.

**Views of
Responsible
Official**

We issued a draft report to the Lottery dated October 20, 2011. Linh Nguyen, Acting Director, responded by the attached letter dated November 8, 2011. Mr. Nguyen agreed with the findings and recommendations.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

December 16, 2011

Findings and Recommendations

FINDING 1— Improve oversight over invoice payment process

Our audit disclosed that the Lottery could have provided better oversight over the invoice payment process.

We tested 7 of 11 invoices (64%) submitted for payment by Otto Construction to the Lottery for the audit period of July 15, 2009, through September 30, 2010. Our audit disclosed that in four of seven (57%) invoices tested that included self-performed work costs, the Lottery did not provide records (e.g., labor, materials, and equipment, etc.) to substantiate the contractor's self-performed work costs totaling \$1,328,292 in claimed costs. In addition, our audit disclosed that all seven invoices reviewed, totaling \$17,460,349 in claimed costs, the Lottery overpaid the contractor for subcontractors' work totaling \$239,281 (not including mark-up and general conditions costs). We identified the following discrepancies:

- The November 2009 invoice, totaling \$228,610, was overpaid by \$15,000. The contractor claimed \$90,000, while the subcontractor had invoiced only \$75,000 for that month.
- The March 2010 invoice, totaling \$2,373,646, was overpaid by \$95,000. The contractor claimed \$95,000. The contractor initially billed \$90,000 (see item above) in November, then billed an additional \$5,000 in January; the contractor then billed the full \$95,000 in March.
- For the April 2010 invoice, totaling \$2,236,936, the Lottery did not provide support to substantiate the contractor's self-performed work of \$537,418. In addition, \$12,260 was overpaid for subcontractor work. The subcontractor billed \$1,520, but the contractor claimed \$13,780. After we made the Lottery contract manager aware of the difference on February 7, 2011, he stated that this overpayment would be corrected in a subsequent invoice.
- The May 2010 invoice, totaling \$2,162,969, was overpaid by \$20,951. The contractor overbilled \$2,240 for a subcontractor, and the Lottery could not provide any support for \$18,711 for "site" module costs.
- For the June 2010 invoice, totaling \$3,435,799, the Lottery did not provide support to substantiate the contractor's self-performed work of \$389,530. In addition, \$31,539 was overpaid. The contractor billed, in May and June 2010, \$31,539 in invoices for the same subcontractor. After we made the Lottery contract manager aware of the difference on February 7, 2011, he stated that the \$31,539 would be corrected in a subsequent invoice.

- For the July 2010 invoice, totaling \$2,811,005, the Lottery did not provide support to substantiate the contractor's self-performed work of \$302,213. In addition, supporting documents were not available for \$1,515 claimed for "exterior envelope" module costs.
- For the August 2010 invoice, totaling \$4,211,384, the Lottery did not provide support to substantiate the contractor's self-performed work of \$99,131. In addition, \$63,016 was overpaid for subcontractor work. After we made the Lottery contract manager aware of the difference on February 7, 2011, he stated that this overpayment would be corrected in a subsequent invoice.

The Lottery's invoice review process includes a pre-invoice meeting held with a core group including Otto Construction personnel, the Lottery contract manager, and Capital Program Management (CPM) representative(s) to review the preliminary invoice. The Lottery contracted with CPM to assist the Lottery's contract manager in the invoice review process. The Lottery's contract manager reviews each invoice with CPM's representative(s) to determine construction progress. After the core group agrees on the pre-invoice, the contractor submits the final monthly invoice to the Lottery for payment. The Lottery's contract manager reviews and approves the invoice for payment.

When the deficiencies were brought to the Lottery management's attention in March 2011, the Lottery contract manager began a payment reconciliation process for the subcontractors. The contract manager stated that, per Contract Exhibit C.4, sections 12.04 and 12.05, contract payments are based on percentage of completion. The contract manager also stated that reconciliations and requests for supporting documents are not required but may be requested. In addition, the contract manager stated that the contractor's self-performed work costs will be reconciled at the end of the contract and if there are any over- or underclaimed amounts, the retainer amount of approximately \$3 million should cover the differences.

Failure to adequately monitor the contractor's claims by not reviewing the support for invoices could expose the Lottery to undue liability because:

- The contract close-out process sometimes is not completed until months or years after a contract ends, at which point the contractor may not have enough money to reimburse overpaid compensation;
- There may be staff turnover; and
- A contractor and/or subcontractors could go out of business given the current volatile economic times.

The Lottery did not verify the actual hard costs of work to supporting documentation. The work costs consist of costs for labor, materials, and equipment.

Contract No. 14379, Exhibit A, Construction Phase, section A.2., states, in part:

Construction Cost - the actual hard cost of the Work (defined as the construction and services required from Contractor by the Contract Documents, whether completed or partially completed, and includes all other labor, subcontractors, materials, equipment and services provided or to be provided by Contractor to fulfill its obligations. . .).

Contract No. 14379, Exhibit C.4, Article 12.05, Formal Application, page 94, states, in part:

Based upon the approved Draft Payment Application, Contractor shall prepare its formal Payment Application, which shall be notarized, if required, and supported by such data substantiating Contractor's right to payment as Owner may require, such as copies of requisitions from Subcontractors and Suppliers. Such applications may not include requests for payment of amounts Contractor does not intend to pay to a Subcontractor or Supplier because of a dispute or other reason, unless Contractor has specifically notified Owner of an intended back charge or dispute, and Owner has nonetheless approved the payment.

The California Lottery Contract Manager's Handbook, Chapter 4 – Invoice Process – Reviewing Invoices, dated June 2007, states, in part:

Conduct a technical review of the invoice when necessary to determine the reasonableness of charges and hours worked. This evaluation is based on the contract deliverables, time sheets, and receipts or other documents on file that may be used to substantiate charges billed.

Review all invoices for accuracy. Verify that the services/equipment has not previously been billed. Cost rates are limited to those specified in the contract. Check all mathematical calculations for accuracy.

Many, or all, of the discrepancies noted above may be disclosed during the close-out process. The Lottery could preclude these discrepancies by improving oversight and/or retaining records to substantiate the amounts claimed and to ensure that payments made were legal, proper, and accurate.

Recommendation

Although the Lottery has indicated various means by which it may adjust/collect amounts that were overpaid, it needs to follow through by making the adjustment to collect the \$239,281. This issue will be reviewed again in a follow-up audit.

In addition, the Lottery should:

- Improve oversight over the payment process to ensure that payments made are legal, proper, and accurate;
- Ensure that sound financial and contract management practices and procedures are implemented to prevent the Lottery's assets from being abused and/or misused;

- Exercise due diligence in the payment application process so that payment applications are reviewed and substantiated in a timely manner or before payments are approved; and
- Request and retain adequate supporting documentation for costs claimed for reimbursement.

Lottery's Response

The Lottery agrees with the finding and recommendation. When deficiencies were brought forward to the Lottery Contract Manager, the Contract Manager began a payment reconciliation process for its subcontractors in March 2011. This includes reconciling the \$239,281 in questioned costs. In addition, the Lottery is currently reconciling all costs claimed by Otto Construction. The reconciliation will be completed by December 2011, which will include requesting documentation to support actual hard costs claimed by Otto Construction. The Lottery looks forward to the SCO follow up audit on the final reconciliation of project payments.

SCO's Comment

The Lottery concurs with the finding and recommendation.

FINDING 2— Lack of authorization for work

Our audit disclosed that the Lottery did not provide prior written authorization to the contractor for additional preconstruction services before commencement of work and/or before compensation. The Lottery's authorization for preconstruction services was issued February 9, 2010; the services were performed during November 2009 and payment was issued January 26, 2010. The Lottery inadvertently made a payment of \$12,351 on an invoice for November 2009 services without prior written authorization from the Lottery.

Contract No. 14379, Exhibit C.3, Article 2.C.2, states, in part:

In addition to the aforementioned fee, the Owner may reimburse the Contractor for miscellaneous items needed to support the Project and/or for additional Preconstruction Services of the trade contractors stated above, if the services/deliverable requested by the Owner or the Integrated Project Delivery (IPD) Team exceed that of a traditional design assist contractor, . . . The Owner's prior written authorization is an express condition precedent to any reimbursement to the Contractor of such costs and expenses, and no claim for any additional compensation or reimbursement shall be valid absent such prior written approval of the Owner.

The Lottery did not provide prior written authorization (before commencement of work or before payments for such services were made) for additional preconstruction services performed by subcontractors. This could result in overpayments to the contractor, inflated billings, and/or misuse and abuse of the Lottery's resources.

Recommendation

The Lottery should:

- Ensure that all additional services are approved and prior written authorization is given to the contractor before commencement of work and before payments for services are made; and
- Retain copies of authorizations for its records.

Lottery's Response

The Lottery agrees with the finding and recommendation and has since ensured that prior written authorization is given for all additional services. In this instance the contractor proceeded on a verbal authorization by the Contract Manager which is not consistent with contract language. The written authorization was processed when the oversight was recognized. The Lottery's Contract Manager retains copies of authorizations related to this contract.

SCO's Comment

The Lottery concurs with the finding and recommendation.

FINDING 3— Lack of liability insurance coverage

Our audit disclosed that there was no evidence to verify that insurance certificates and bonds coverage forms were received by the Lottery within five days of receipt of the Notice-to-Proceed (authorization for construction services) and before commencement of the work. The Certificate of Liability Insurance provided to us for review was dated February 19, 2010, which is three months after the initial authorization for construction services dated November 17, 2009. In addition, the issue date for the bonds provided to us was June 2, 2010, which was approximately seven months after the first authorization for construction services and commencement of work.

Contract No. 14379, Exhibit C.4, Section 3.01, Bonds: Time to Submit, states, in part:

Within five (5) days after receipt of the Notice to Proceed and before the commencement of the Work, the Contractor shall furnish and deliver to the Owner bonds as set forth below. . . .

Contract No. 14379, Exhibit C.4, Section 3.12, Insurance Qualification, states, in part:

Contractor shall procure and maintain in effect at all times during the term of this Contract, such insurance in companies having at least a rating of A-Level VII, . . . or otherwise satisfactory to Owner. In Addition, certified copies of all insurance policies required will be provided to the Owner within five (5) days of receipt of Notice to Proceed and before commencement of the Work.

The lack of timely and adequate liability insurance and bonds coverage could inadvertently expose the Lottery to unnecessary liability and risk. The Lottery's staff failed to provide us with adequate documentation proving that the liability insurance policies and bonds coverage were received within five days of the issuance of the Notice to Proceed and commencement of the work.

Recommendation

The Lottery should:

- Monitor the Otto Construction contract terms and conditions to protect against any unnecessary potential liability associated with this contract; and
- Conduct periodic review of the insurance policies and bonds coverage files to ensure that adequate coverage is maintained and that all documents are received in a timely manner.

Lottery's Response

The Lottery agrees with the finding and recommendation and moving forward will monitor its liability insurance and bond certification documents to ensure they are received in accordance with contract terms and Lottery policy. As a note, the Lottery's liability insurance and bond coverage were in focus throughout construction; however, the certification documents evidencing that coverage was in place was not received by the Lottery within five days of construction authorization.

SCO's Comment

The Lottery concurs with the finding and recommendation.

FINDING 4— Noncompliance with as-built drawings and specifications

Our audit disclosed that the Lottery's contract manager did not submit written confirmation with the progress payment application request (invoice) showing that the as-built drawings and specifications have been properly updated on a weekly basis. No written confirmations were submitted with invoices showing that as-builts have been properly updated during our audit period of July 15, 2009, through September 30, 2010, which included 11 claim schedules.

Contract No. 14379, Exhibit C.4, Article 5, Section 5.07, states, in part:

The Contractor shall maintain a master set of Plans and Specifications at the Site, which shall be updated to reflect current as-built conditions of the Work as the Work progresses. The information to be recorded by the Contractor will be determined by the Architect, who will be responsible for preparing the final, reproducible as-built drawings based upon the information submitted by the Contractor. . . . The updated Plans and Specifications shall be available for review by the Contract Manager.

Written Confirmation from the Contract Manager that the as-builts have been properly updated weekly shall be submitted with each Progress Payment Application request, and the existence of such properly updated as-builts shall be a condition precedent to payment. Failure to comply with the preparation and submission of as-builts may result in the Owner withholding the current progress payment.

Contract No. 14379, Exhibit C.4, Article 12, Section 12.08, states, in part:

The Core Group will promptly review the Payment Application to confirm compliance with the amounts approved by the IDP Team in the Draft Payment Application and terms of the Contract Documents.

The Lottery's failure to document that as-built drawings and specifications were being properly updated, reviewed, and maintained in a timely manner could result in vital information such as electrical, plumbing, mechanical installations, and changes in construction being excluded from the building's final drawings and specifications. The Lottery did not provide written confirmation that the as-built drawings and specifications were properly updated in a timely manner as required by the contract.

Recommendation

- The Lottery should develop and implement a process in which progress payment application requests include contractor manager's written confirmation that the as-builts have been properly updated before a payment is approved.
- The Lottery should develop and implement a second-level review in which someone other than the contract manager reviews the progress payment application request to ensure that all documents required by the contract are included with the application.

Lottery's Response

The Lottery agrees with the finding and recommendation. The Lottery will ensure that future progress payment application requests include the Contract Manager's written confirmation that as-built plans have been properly updated before a payment is approved. Further, the Lottery will develop and implement a second-level review in which someone other than the contract manager reviews the progress payment application request to ensure that all documents required by the contract are included with the application. It is important to note that as-built drawings and specifications are available at Otto Construction's on-site office. The Lottery's Inspector of Record (IOR) regularly monitors the as-built drawings to ensure they are properly updated in a timely manner.

SCO's Comment

The Lottery concurs with the finding and recommendation.

**FINDING 5—
Lack of contractor's
daily reports**

Our audit disclosed that the Lottery did not ensure that the contractor provided daily reports on the Lottery's specified Contract Attachment Form E. We did not observe any daily reports and/or Form E from the contractor during the audit period.

Contract No. 14379, Exhibit C.4, Section 8.08, Daily Reports, states, in part:

No less than on a weekly basis, the Contractor's superintendent shall submit daily activity reports for each workday including weekends and holidays, when worked, to the Contract Manager on the Owner's furnished form.

Failure to document fully what work was done, when, and by whom could expose the Lottery to potential liability for untendered services, incomplete work, and low-quality services.

The contractor's superintendent did not provide any daily reports to the Lottery's contract manager during our audit period ending September 30, 2011. However, daily reports for the individual subcontractors were provided and maintained.

Recommendation

The Lottery should ensure that the contractor's superintendant completes the daily reports on a weekly basis per the contract terms and conditions.

Lottery's Response

The Lottery agrees with the finding and recommendation and will ensure that Otto Construction's superintendent completes, and submits daily reports on a weekly basis per the contract terms and conditions. The Lottery relied on daily reports from the Lottery's IOR to document what work was done, and to ensure it was completed to the quality standards expected. While the IOR daily reports provide a level of assurance to the Contract Manager, they are not a substitute for Otto Construction's daily reports.

SCO's Comment

The Lottery concurs with the finding and recommendation.

**OBSERVATION—
New headquarters
depreciation expense**

We noted that the depreciation cost for the new building will be included in the Lottery's administrative expense for fiscal year 2011-12, which is limited to 13% of total revenues.

Per Lottery Commission minutes dated June 26, 2009, construction payments to the contractor will be recorded as an asset. This means cash outlays are not reflected as an expense. Once the building is occupied, the cost of the asset (building) will be depreciated over 39.5 years. The depreciation cost will be a component of the Lottery's administrative expense, which is limited to 16% of total revenues.

However, the administrative expense requirement changed with the passage of Assembly Bill (AB) 142. The amount that could be spent for Lottery's expenses was reduced to no more than 13% of total revenues.

California Government Code section 8880.64 states, in part:

(b) (1) Not more than 13 percent of the total annual revenues accruing from the sale of all lottery tickets and shares from all lottery games shall be expended for the payment of the expenses of the lottery.

Recommendation

The Lottery's management should comply with California Government Code section 8880.64 and ensure that expenses do not exceed the new limitation.

Lottery's Response

The Lottery agrees with the observation and recommendation. As a note, Fiscal Year 2010-11 Lottery expenses were 12.6 percent of total revenues and in compliance with Government Code section 8880.64.

SCO's Comment

The Lottery concurs with the observation and recommendation.

**Attachment—
California Lottery's
Response to Draft Report**



November 8, 2011

Jeffrey V. Brownfield, Chief
Division of Audits
State Controller's Office
Post Office Box 942850
Sacramento, California 94250-5874

Re: OTTO CONSTRUCTION CONTRACT

Dear Mr. Brownfield:

The California State Lottery (Lottery) offers the following general comments and specific points regarding the recently concluded audit conducted by the State Controller's Office (SCO). The audit scope was limited to an audit of the Lottery's fiscal controls over the monitoring of the Otto Construction contract.

The draft report lists five findings, one observation and six recommendations for the Lottery to consider. The Lottery finds these recommendations useful and has implemented corrective actions after notification of deficiencies during the audit.

Below are the Lottery's responses to the specific recommendations provided in the draft audit report.

FINDING 1 – Improve oversight over invoice payment process

RECOMMENDATION:

Although the Lottery has indicated various means by which it may adjust/collect amounts that were overpaid, it needs to follow through by making the adjustment to collect \$239,281. This issue will be reviewed again in a follow-up audit.

In addition, the Lottery should:

- Improve oversight over the payment process to ensure that payments made are legal, proper, and accurate;
- Ensure that sound financial and contract management practices and procedures are implemented to prevent the Lottery's assets from being abused and/or misused;

- Exercise due diligence in the payment application process so that payment applications are reviewed and substantiated in a timely manner or before payments are approved; and
- Request and retain adequate supporting documentation for costs claimed for reimbursement.

RESPONSE:

The Lottery agrees with the finding and recommendation. As noted in the report, when deficiencies were brought forward to the Lottery Contract Manager, the Contract Manager began a payment reconciliation process for its subcontractors in March 2011. This includes reconciling the \$239,281 in questioned costs. In addition, the Lottery is currently reconciling all costs claimed by Otto Construction. The reconciliation will be completed by December 2011, which will include requesting documentation to support actual hard costs claimed by Otto Construction. The Lottery looks forward to the SCO follow up audit on the final reconciliation of project payments.

FINDING 2 – Lack of authorization for work

RECOMMENDATION:

The Lottery should:

- Ensure that all additional services are approved and prior written authorization is given to the contractor before commencement of work and before payments for services are made; and
- Retain copies of authorizations for its records.

RESPONSE:

The Lottery agrees with the finding and recommendation and has since ensured that prior written authorization is given for all additional services. In this instance the contractor proceeded on a verbal authorization by the Contract Manager which is not consistent with contract language. The written authorization was processed when the oversight was recognized. The Lottery's Contract Manager retains copies of authorizations related to this contract.

FINDING 3 – Lack of Liability Insurance Coverage

RECOMMENDATION:

The Lottery should:

- Monitor the Otto Construction contract terms and conditions to protect against any unnecessary potential liability associated with this contract; and
- Conduct periodic review of the insurance policies and bonds coverage files to ensure that adequate coverage is maintained and that all documents are received in a timely manner.

RESPONSE:

The Lottery agrees with the finding and recommendation and moving forward will monitor its liability insurance and bond certification documents to ensure they are received in accordance with contract terms and Lottery policy. As a note, the Lottery's liability insurance and bond coverage were in force throughout construction; however, the certification documents evidencing that coverage was in place was not received by the Lottery within five days of construction authorization.

FINDING 4 – Noncompliance with as-built drawings and specifications

RECOMMENDATION:

- The Lottery should develop and implement a process where progress payment application requests include contract manager's written confirmation that the as-builts have been properly updated before a payment is approved.
- The Lottery should develop and implement a second-level review in which someone other than the contract manager reviews the progress payment application request to ensure that all documents required by the contract are included with the application.

RESPONSE:

The Lottery agrees with the finding and recommendation. The Lottery will ensure that future progress payment application requests include the Contract Manager's written confirmation that as-built plans have been properly updated before a payment is approved. Further, the Lottery will develop and implement a second-level review in which someone other than the contract manager reviews the progress payment application request to ensure that all documents required by the contract are included with the application. It is important to note that as-built drawings and specifications are available at Otto Construction's on-site office. The Lottery's Inspector of Record (IOR) regularly monitors the as-built drawings to ensure they are properly updated in a timely manner.

FINDING 5 – Lack of contractor's daily reports

RECOMMENDATION:

The Lottery should ensure that the contractor's superintendent completes the daily reports on a weekly basis per the contract terms and conditions.

RESPONSE:

The Lottery agrees with the finding and recommendation and will ensure that Otto Construction's superintendent completes and submits daily reports on a weekly basis per the contract terms and conditions. The Lottery relied on daily reports from the Lottery's IOR to document what work was done, and to ensure it was completed to the quality standards expected. While the IOR daily reports provide a level of assurance to the Contract Manager, they are not a substitute for Otto Construction's daily reports.

Jeffrey V. Brownfield
November 8, 2011
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OBSERVATION – New headquarters depreciation expense

RECOMMENDATION:

The Lottery's management should comply with California Government Code section 8880.64 and ensure that expenses do not exceed the new limitation.

RESPONSE:

The Lottery agrees with the observation and recommendation. As a note, Fiscal Year 2010-11 Lottery expenses were 12.6 percent of total revenues and in compliance with Government Code section 8880.64.

If you have any additional questions, please contact my Audit Chief, Roberto Zavala at (916) 822-8358.

Sincerely,

A handwritten signature in black ink, appearing to be 'Linh Nguyen', with a stylized flourish at the end.

Linh Nguyen
Acting Director

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>